



Information exchange and global economic regulation—for whose benefit?

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Offshore financial centres have both the sovereign right and the moral right to insist that information exchange be limited to matters of common criminality and governed by due legal process for the protection of both their own residents and citizens and their own economic interests. There is nothing wrong, immoral or unnatural about sovereign countries competing for investment by offering differing legal and economic regulatory systems.

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Since its 1998 report on harmful tax competition, the Organisation for Economic Cooperation and Development (OECD) has been waging a diplomatic offensive to force offshore financial centres (OFCs), often described as tax havens, to remove 'harmful' tax practices. The OECD report and its lack of theoretical economic reasoning have been severely criticised.¹ Partly in unacknowledged response to such criticism, and due to a lack of apparent enthusiasm in the United States for a global tax cartel, the OECD now states that it wants to promote tax competition. The OECD's notion of tax competition is not unfettered fiscal competition between nation states but its own definition of fair tax

competition based on its own particular and parochial sensibilities. As the self-appointed fiscal headmaster for the world, the OECD insists that tax competition cannot be fair without information disclosure on request across national borders.

Now, in the wake of the September 11 terrorist attacks in the United States, new laws are being adopted against the financing of terrorism (including worldwide tracing and seizure of funds) with far-reaching ramifications for tax information disclosure regimes worldwide, making it far more likely that the OECD's demands will be implemented. International cooperation against criminal activity is entirely



warranted, but such cooperation and information sharing also serves as a precedent for international tax information disclosure. This article examines the problems arising when one country agrees to act as tax collector for others. It is suggested that the traditional rule of international law enforcement cooperation requiring dual criminality is a logical one and that international cooperation on terrorism is not, and should not be, the precedent for tax information exchange on the lines desired by the OECD.

This paper does not suggest that tax avoidance or evasion are desirable *per se*. Rather, it argues that many other features of modern life which are also undesirable or detrimental have not received equal attention.

The great trouble with the increasingly strident attacks is that all too often it is accepted that there is only one view of what is moral. Users of OFCs and those countries whose OFCs provide employment and income are not to be condemned as immoral merely because they seek or offer some kind of economic freedom or financial privacy. In this regard, OECD appeals to morality can mask a ruthless pursuit of perceived economic self-interest.

What does the OECD want?

The OECD wants OFCs to amend their domestic laws so that records are created and maintained of beneficial ownership or control of OFC companies or trusts (transparency). It also wants tax collectors in OECD countries to be able to obtain information on demand from citizens or residents of those countries (exchange of information). Such changes in the laws of OFCs would assist OECD countries in enforcing civil and criminal tax liabilities against OECD residents who may have assets in tax havens.

The reason the OECD wants to force OFCs to impose such obligations on their

own citizens and residents is that OECD countries have difficulty enforcing taxes on OECD residents in relation to income earned by offshore entities. While it is relatively easy to tax dividends or interest received from overseas, it is more difficult to tax income which remains offshore in foreign companies or trusts. For that reason, many OECD countries have adopted deeming provisions in their tax laws which treat the income of certain foreign companies or trusts as the income of OECD residents who may be shareholders or beneficiaries in such companies or trusts. These deeming provisions are often presented as being a necessary part of residence-based income tax systems under which a country taxes its residents on both their domestic and foreign source income.

Three points need to be stressed. First, there is nothing canonical or sacred about a residence-based income tax. Many countries have operated territorial income tax systems under which the problem of chasing income in tax havens does not arise. Second, the deeming provisions used to back up residence-based taxation often involve legal fictions under which OECD resident taxpayers are expected to pay tax on income which is not legally theirs and which may never be theirs. Third, these deeming provisions are conceded by the OECD itself to be hostile domestic countermeasures against tax havens.²

How does the OECD justify its demands?

On the face of it, it is a remarkable thing that an unelected international secretariat of OECD bureaucrats should be seeking to dictate to sovereign countries the duties and obligations to be imposed on their citizens and residents, even to the extent of overriding domestic constitutional or other legal protections for citizens' privacy.



Naturally, such a demand cannot be made except from some high moral ground. The OECD appears to base its moral stance on the apparently simple proposition that every country has a duty to refrain from encouraging the residents of other countries to seek escape from tax burdens.

It should be noted immediately that the source of such a duty is not obvious in either ethics or international law. So far as ethics is concerned, to argue for such a duty requires implicit acceptance that the tax laws of other countries are always ethical or just (or at least, the tax laws of OECD countries are uniformly ethical or just). Taxation laws normally demonstrate the arbitrary nature of positive law or regulation, rather than any immutable moral or ethical verities. If taxpayers choose to flee their own tax systems, why should a foreigner decide on the morality of their actions? To suggest that other countries have a duty to prevent capital flight from a foreign jurisdiction is extremely presumptuous. Money, like water, flows according to natural laws and perhaps OECD countries complaining of losing it should look to whether their own positive taxation laws are opposed to natural economic laws.

So far as international law is concerned, the collection of taxes or tribute is a sovereign act. Historically, only vassal or subordinate polities have collected taxes for a superior power. Sovereign countries do not collect other countries' taxes. The general proposition that a foreign tax claim cannot be enforced directly or indirectly (for example, through collateral insolvency proceedings), is well established, certainly as far as the United Kingdom is concerned, by a number of cases over many years (see Morris 1980). The enforcement of a claim for taxes is but an extension of the sovereign power which imposed the taxes and an assertion of sovereign authority by one state within the territory of another is (treaty or convention apart) contrary to all concepts of independent sovereignties.

Economic background

Industrial economies levy high income taxes in order to pay for high spending on age pensions and welfare recipients. But income taxes on capital income are hard to enforce if capital can flee across borders. Labour income taxes are already high and revenues from this source will shrink as populations age and people retire from the workforce.

From the conventional OECD point of view, OFCs (or 'tax havens') help OECD taxpayers avoid taxes on capital income which rightly belongs to the OECD home country. However, the logic of this OECD economic argument does not stand up (Dwyer 2000). The OECD has failed to engage in real debate on the substantive issues or to answer questions such as

- what is the logical basis for presuming the superior neutrality of OECD residence country income taxation over the rights of source countries when fiscal systems and public expenditure benefits are not identical?
- why should 'residence' taxation extend in any case to imposing OECD income taxes on the incomes of (non-OECD resident) companies or trusts in other countries, through deemed attribution to OECD residents who may have no rights to such income?
- why does the OECD not consider recommending territorial taxes on immobile factors to its members as a form of self-help against so-called 'harmful tax competition'?
- if OECD countries are concerned that multinational corporate groups may relocate head offices or regional headquarters to OFCs as e-commerce develops, why is that something which OFCs should be expected to discourage?
- why does the OECD not recommend expenditure restraint to its members as a solution to high and uncompetitive tax regimes?



- why does the OECD not recommend to European countries that relaxation of immigration restrictions against citizens of developing countries might help them replenish their diminishing labour tax bases?
- is it not natural that capital would seek to emigrate from countries which impose high taxes, stop their populations from growing and reject immigrants, thereby limiting the scope for profitable employment of capital?
- why should a sovereign country be expected to curtail the rights of its own citizens or impose demands on them (for example, through breaching confidentiality or imposing unnecessary record keeping or audit requirements) for the benefit of another country's tax collectors?

No country has to tax capital income. Land, unlike capital, is an immobile tax base. In economic theory, there are only three things you can tax—land, labour or capital—and only one of them cannot flee (or stop regenerating).

As for declining labour income tax bases, if residents of OECD countries are having fewer children but those countries refuse to allow increased immigration, then who is responsible for shrinking labour tax bases? It is arguable then, that the OECD has only itself to blame if OECD countries attempt to tax a mobile tax base like capital income instead of an immobile one like land. If OECD countries choose to tax business profits and workers so heavily instead of landholders, they must accept the natural economic consequences of capital flight and falling birthrates.

From a moral point of view, it might also be seen as questionable for wealthy OECD countries to demand that small developing countries help them collect taxes (on income belonging to OFC entities) while refusing to let those small countries export labour to OECD countries experiencing labour

shortages. More than one economist has noted the paradox of moves towards free trade in goods and services and free movement of investment capital coinciding with increased restrictions on the mobility of labour. In this regard, it is noteworthy that the European Union did accept the need for free mobility of labour as part of the completion of the European common market, while tax harmonisation and tax cooperation have lingered behind. If the European Union thinks free trade in services and free movement of labour are of greater importance than tax harmonisation or cooperation, why are small developing countries not entitled to share this view?

Given that self-determination is an inherent aspect of national sovereignty, it is worth examining the practical and logical issues which confront a small country in deciding whether or not to agree to cooperate with the OECD demands on tax havens and, if inclined to cooperate, what it should seek in return. It is also worth examining the emerging belief that offshore financial centre privacy is a cloak for all sorts of illicit activities through the misuse of offshore companies.

What is a reasonable *quid pro quo* for information exchange?

The OECD's demands on harmful tax competition originally fell into three groups—transparency, ringfencing and exchange of information (all subsumed under the idea of 'fair' tax competition). Demands for ringfencing have waned since most OECD countries themselves could not conform to that original requirement. The OECD demand for 'transparency' requires offshore centres to ensure that their domestic laws are altered to require creation and maintenance of records setting out the beneficial ownership or control of trusts and companies. In turn, these records will be available to answer inquiries from OECD



countries. Although the requirement of transparency is generally thought of as appropriate to making governments accountable to their electors, the OECD requirement will be imposed on the private sector. It does not matter if neither the private sector nor the government of an offshore country see any need to create or maintain such databases or wish to protect information under data or privacy protection laws. With regard to the 'exchange' of information, in practice, information flow is likely to be virtually one-way—from the tax haven to OECD countries to allow them to tax their residents on their overseas interests or deemed interests.

The first thing to observe is that agreements for exchange of information for tax purposes are normally found only in full double taxation agreements. The starting point for an offshore financial centre in dealing with an OECD country should therefore be that exchange of information for tax purposes be considered solely in the context of a full double taxation agreement. An OFC agreeing to exchange of information might expect the full benefits of a double tax treaty. Such benefits might include

- reduced withholding taxes on dividends and interest flowing from an OECD country to the OFC
- a business profits exclusion rule to ensure that investors from the OFC in the OECD country who did not have a permanent establishment in the OECD country would not be subject to tax in the OECD country
- concessional or zero capital gains taxation on disposal of assets in the OECD country by investors from the OFC.

There are also other issues relevant to OFCs in any information exchange with an OECD country, including immunities for its public officials or residents, revenue sharing, user pays (that is, treaty partners) funding of information gathering and abolition of existing OECD countermeasures.

Further, exchange of information articles in full double taxation agreements are generally subordinated to the local legislation of each country. The most widely used OECD model convention excludes the exchange of information where the recipient of the information request would use it to carry out administrative measures at variance with the laws or the administrative practice of either state, or if the information is not obtainable under the information collecting powers of the recipient state or would disclose trade, business, industrial, commercial or professional secret or trade processes, or information the disclosure of which would be contrary to public policy.

Thus, if a country has strict bank secrecy, such as Switzerland or Singapore, its local tax authority cannot provide more in response to a request for information from a treaty partner than it could obtain under local practices. Similarly, given that the US Constitution prohibits unreasonable searches and seizures, a treaty partner of the United States cannot expect the US Internal Revenue Service to provide information which would require a search warrant authorising activities outside the scope of US law and its constitutional limitations.

If there are global tax norms (a proposition which may be severely doubted), then the OECD tax treaty system would be a logical place to look. Although the OECD may reply that it is revising its model treaty, there are literally hundreds of treaties still in force based on previous OECD and UN tax treaty models. These treaties contain a very different set of tax norms to those seeking unilateral surrender of information. No country agrees to force its citizens or residents to provide information for another country unless there is a significant benefit in doing so, a benefit which justifies overriding protection of the individual rights of owners of information, including data protection and privacy rights. The long history of negotiations on double taxation agreements since the 1920s shows



that most countries will only agree to exchange of information for tax purposes if they are assured of substantial concessions as a *quid pro quo* from the treaty partner.

The jurisprudence of international tax

The fundamental understanding in all international tax negotiations is that taxation is a sovereign act. Even within federations, it has been recognised that no state has an obligation to assist the revenue collectors of another state.

It is always open to jurisdictions to agree to enforce each others' taxes, as has occurred between Australian states. The salient point remains that no jurisdiction has the slightest duty to agree to anything that is not in its own interests. This principle also applies to self-governing colonies in the British tradition. As Pitt the Elder noted in his speeches on the American Revolution,³ it is a fundamental principle of English law that the sovereign has no right to put his hands into the people's pockets without their consent, and that consent can only be given by a local parliament agreeing to local tax laws.

Further considerations

On the question of benefits from a tax treaty, if an OFC were to agree to a full double taxation agreement with an OECD country it would also need to seek some further concessions on tax sparing. There is not much point in offering tax incentives or being a tax-free jurisdiction if those tax exemptions are wiped out by other countries imposing taxes on the exempted income. That is basically what OECD residence taxation does. In this context, it should be noted that at around the same time as the OECD produced its report on harmful tax competition (OECD 1998) it also produced another report on tax sparing (OECD 1999) recommending that OECD

countries rethink their willingness to forgo taxation on income exempted from tax through incentives in developing economies, such as Malaysia and Singapore.

The OECD has recommended countermeasures against OFCs not agreeing to exchange of information.⁴ Many of those countermeasures already exist. Accordingly, an offshore financial centre being asked to provide information for tax purposes to an OECD country might well wish to demand that the OECD country remove its existing countermeasures, as well as agreeing to a full double taxation agreement and tax sparing recognition of the OFC's tax incentives.

Among the most important countermeasures already in existence are legislation on controlled foreign companies, passive investment funds and transferor trusts. Essentially, this legislation seeks to bypass the normal legal rules on residence or source of income to tax OECD residents not on their *actual* foreign income, but on income of foreign entities which it deems under domestic law to be the income of its residents. Thus, income arising in an OFC to an OFC company or trust may be taxed by an OECD country even if no OECD resident has any right to that income. Such legislation in OECD countries has increasingly become the norm but was originally highly controversial. Switzerland took the view that it was fundamentally contrary to a double taxation agreement for one OECD country to seek to tax income arising to a company or trust in another country by attributing that income to its own domestic taxpayers.

There is not only a large degree of arbitrariness about the deeming processes in these legislative countermeasures; from the point of view of an OFC seeking to attract investment capital, such provisions may be viewed as a discriminatory OECD export tax on capital. The logical question to ask is why would a small offshore financial centre cooperate in a double tax agreement with an OECD country that is not only unwilling to



remove tax barriers to the free flow of capital but tries to impose them through the back door? Why should any developing economy be expected to assist OECD countries tax the income of companies and trusts in that country? Surely it is for each country to decide whether or how to tax entities or relationships established under its laws? If an OFC wants to encourage local economic growth through exempting its financial services sector, why should it be expected to wipe out those incentives for the benefit of OECD countries richer than itself?

What if a full double taxation agreement is not possible?

The OECD demand for information exchange has thus far been discussed in the context of double taxation agreements. However, any treaty requires the agreement of two parties. It is unlikely that an OECD country would agree to a proposal for information exchange for tax purposes with an offshore financial centre on the basis outlined above, involving a full double taxation agreement, tax sparing, and withdrawal of countermeasures. To do so would be to acknowledge the legitimacy of the right of OFCs to compete for investment capital with full recognition of their sovereign right not to impose taxes.

An apparent unwillingness to accord such recognition of fiscal sovereignty to OFCs seems to be why the OECD has not pursued information exchange for tax purposes in the normal context of full double taxation agreements with OFCs. Instead, the OECD has increasingly shifted its lines of argument from 'harmful tax competition' (a debate which was not sustainable) to a focus on information exchange for law enforcement purposes. Having failed to gain consensus on the alleged evils of 'harmful' tax competition, the OECD has refocused its aim on the evils of tax avoidance and evasion

(which the OECD apparently regards as indistinguishable) and has urged multilateral support for measures to enforce unilateral information exchange from OFCs. The argument put is essentially simple: without worldwide information gathering, tax systems which tax worldwide income of residents cannot be enforced. This is part of the so-called 'dark side' of globalisation—the increased ability of OECD taxpayers to minimise their tax obligations. Therefore, to stop capital flight from high tax countries and to ensure 'equity', low tax OFCs should provide information to OECD countries on request to allow OECD countries to check up on their taxpayers.

Civil versus criminal law cooperation

At first blush, such cooperation against alleged 'economic criminals' may appear reasonable. Nations have traditionally cooperated on matters of common criminality. The basic rule of international law is that one jurisdiction may help another in a criminal matter where the alleged offence is criminal under both systems of law (the rule on dual or common criminality). The OECD, however, views the present rule on common criminality as too narrow and urges that, as a matter of comity between nations in a globalising world, it is now necessary for OFCs to agree to information exchange for both civil and criminal law enforcement purposes, including both criminal and civil tax matters.

Tax evasion and avoidance in relation to the rule on common criminality

Such a position represents a drastic expansion of de facto extra-territorial law enforcement beyond the borders of OECD countries, but the traditional rule on common



criminality makes logical sense and ought not be set aside. Essentially, the rule on common criminality as a precondition for mutual legal assistance or information exchange recognises that each sovereign country is master in its own house. No country exists to enforce the laws of another country; if any country enacts tax laws which need extra-territorial enforcement, that is its own problem: no one is preventing that country being more sensible and only taxing economic activity arising within its borders.

It seems that the OECD is trying to undermine this fundamental international law objection to information disclosure based on the prerequisite of common criminality. The argument is put that information disclosure from OFCs upon request by OECD countries is necessary for them to prevent tax evasion according to their own laws. The reasoning is that tax evasion is fraud, fraud is criminal under most legal systems and therefore information exchange for tax purposes is justified on the basis that fraud is criminal everywhere. This sort of argument has had some success but it still seems fundamentally inconsistent with the traditional rule that countries do not enforce each other's tax laws.⁵

The question remains: why should anyone be obliged to help high-taxing OECD countries stop capital flowing to where taxes are lower? The capital flowing away belongs to their citizens, not to OECD governments, and other countries do no injury to anyone's rights if they make such capital welcome.

The assertion that OFCs should provide information for tax purposes to OECD countries raises some further questions, namely,

- why should legal assistance not be limited by the traditional rule on dual criminality?
- given that national revenue laws all differ so much, if a developing economy were to assist in the application of other country's revenue laws in respect of acts committed in its territory, what

immunities would its companies, citizens or residents have from prosecution by other countries on pretended charges of complicity in alleged revenue fraud, even though what was done in the developing economy was perfectly legal under its laws? Will assisting the extra-territorial application of OECD criminal revenue laws mean that citizens or residents of developing countries could be charged under other countries' laws for acts which were legal when and where they were done? Are OECD countries committed to respecting the operation of developing countries' laws relating to the legality of acts committed in those countries?

- given that both the UN and OECD model tax conventions recognise the legitimacy of source country taxation and territorial tax systems, what basis is there in international law for European OECD countries (many of which have employed territorial systems) to expect developing countries to give priority to residence countries' tax claims by agreeing to the criminalisation of the use of territorial tax systems by OECD investors offshore?
- what burdens or obligations to create, produce papers or give evidence would be imposed upon companies, citizens or residents, were the country to agree to OECD demands for information exchange? Why should new obligations to create records for the benefit of a foreign state be enacted by any country?
- where a country has a constitutionally-entrenched right to privacy of personal papers, as in Article IV of the Bill of Rights of the United States of America, why should foreign tax collectors expect that country to force its citizens or residents to supply information without any legal process for issuing and testing warrants through judicial due process?
- if a country were to agree to assist in the enforcement of other countries' revenue laws, what share of those countries'



revenues would be paid to that developing country? If none, why should any sovereign country be expected to disregard its own interests so completely?

- do all OECD countries distinguish between tax evasion and tax avoidance, and do they all recognise the lawful right of free citizens to dispose of their property as they think fit? If not, do they expect other countries with a more refined sense of the rule of law to assist them treat as criminal offences matters which are merely the exercise of rights to dispose of property?
- if tax evasion is treated as a criminal rather than a civil matter in some OECD countries, are taxpayers in those countries given the normal criminal protections such as the onus of proof lying on the prosecution and the right not to be forced to incriminate oneself? If they are not, why should such an OECD country expect another country to lower its normal protections for an accused in relation to acts which are in any case lawful in that other country?

In any event, tax planning or tax avoidance is not fraud (no matter how unappreciated by revenue officials). Tax administrators are, however, often not inclined to distinguish between tax evasion and tax avoidance. Increasingly, revenue authorities in OECD countries tend to take the view that any attempt at aggressive tax planning is essentially tax evasion and may be prosecuted as a criminal activity.

Interestingly, tax evasion has not always been dealt with as a form of fraud in law. Tax evasion was not dealt with normally as a criminal matter in many countries precisely because taxpayers were expected to supply voluntarily the information which would expose them to financial liabilities. For example, in Australia before 1980, the normal practice on matters of tax evasion was—and generally still is—to impose penalty tax

administratively without any court case to prove criminal fraud.

If tax evasion were treated as a normal criminal matter, taxpayers could justify their refusal to answer tax return questions, or to allow access to documents on request on the basis that such demands violate the normal rule against self-incrimination (which incidentally does apply to pecuniary penalties such as taxes). The routine administration of taxes would become impossible if a large number of taxpayers were treated as potential criminals who in turn demanded their rights to the normal protections for the accused under criminal law. In order to avoid such procedural paralysis, the compromise developed that tax authorities were given enormous inquisitorial powers (far greater than any powers given to police) to investigate taxpayers affairs without search warrants or other legal protections on the corresponding understanding that taxpayers would not be treated as criminals and that any tax deficiency would be recovered through administrative penalties as a debt.

Another *quid pro quo* was that taxpayers were often assured by statutory guarantees that their personal financial affairs would be kept secret and not disclosed to other authorities such as the police. For example, a prostitute could file a tax return disclosing the source of her earnings without risking prosecution.

In recent years, however, such balances of public policy interests have been eroded in OECD countries. OECD taxpayers can often face both civil and criminal proceedings for the same default without the normal protections owed to the suspect or the accused in the criminal law. It is precisely because of the uneasy overlap between civil and criminal categories, and the often blurred distinction in administrative and judicial practice between avoidance and evasion in tax matters, that it is technically dubious to assert broadly that tax defaults are all simply



a form of fraud covered by the international law rules on mutual assistance in matters of common criminality. Such doubts explain why countries have usually declined to enforce, or assist in the enforcement of, other countries' taxes in any way.

Thus, there is still compelling logic in favour of the traditional treatment of taxes as pecuniary penalties imposed by a sovereign and with which another sovereign need not concern himself. Whether civil or criminal, taxes still represent pecuniary penalties rather than normal commercial debts, and it is not the job of one sovereign to collect them for another.

Privacy and human rights— security of capital

From the point of view of an offshore financial centre seeking to attract capital, other serious questions are raised by demands for information disclosure for other countries' law enforcement purposes. Increasingly, arguments are being made that corporate vehicles are being used for illicit purposes besides tax evasion or avoidance, such as corporate law manipulations, insider trading, exchange control avoidance, hiding assets from creditors or spouses, as well as avoidance of forced heirship rules.⁶ Whether one regards such purposes as legitimate or illicit (which arguably depends upon the circumstances of each case), the argument is made that disclosure of information (for example, beneficial ownership) is necessary if OECD countries are to prevent avoidance of their laws through the use of offshore vehicles.

A country can only develop and attract capital investment if it can offer secure property rights. That means what it says: private property is private, not transparent. You cannot have private property without privacy. You cannot attract private investment if its details are to be made public to every inquisitive foreign bureaucrat.⁷

The recognition that privacy and private property go together is why many countries, including the United States, have constitutional provisions protecting private citizens from arbitrary searches and seizures, and laws impairing the performance of contracts, guaranteeing privacy and preventing unjust taking of private property.

A country will not experience economic development if local and overseas investors fear the disturbance of their commercial affairs or the taking of their property by government officials. Governments exist to protect people's rights and to protect them in their life, limb and property. Once governments cease to do so and are perceived to prey upon private commercial interests, merchants and others seek to take their wealth elsewhere. Concrete examples of capital flight in these circumstances are sadly too numerous to catalogue here.

Any form of information disclosure concerning the affairs of a private citizen is inherently a diminution of rights of private property. For example, it has always been part of the common law duty of bankers to keep their customers' affairs confidential. There are very good reasons for that, including the obvious risk of damage to a customer's credit. It may therefore be seen as somewhat peculiar that the OECD has supported the growth of market capitalism throughout the world, yet, through demands for information disclosure, is now undermining the security of private property upon which nations depend for their prosperity. At the same time, OECD governments are loudly proclaiming Data Protection and Privacy Acts while busily seeking to allow their officials increased powers to invade the privacy they purport to protect. Against this background, it must be remembered that privacy is both a human right and a property right. If information is to be sought within a country's borders, the citizens of that country may well insist that it should only be available under very strict safeguards.



Modern economists and business people often take the legal foundations of a free society and a free market economy for granted. But the declaration of the rights of individuals evolved as concrete response to abuse of state power. It is noteworthy that Adam Smith bases his first objection to taxing capital⁸ on the intolerable vexation an inquisition into every man's affairs would involve. The sentiment of common law jurisprudence in England has always been that the subject is free and that the common law exists to protect his property and his privacy, the paramountcy of the liberty of the subject as against the power of the state. Continental legal systems by contrast have traditionally typified the relationship of the state and the subject as one of subordination of the liberty of the governed to the requirements of the state.

Among the common law rights of the people which have been protected over the centuries are

1. the right to trial by jury
2. the presumption of innocence
3. the right not to be forced to incriminate oneself
4. the right not to be arrested or invaded in one's privacy other than by judicially-supervised warrants based on cause
5. the right not to be deprived of life, liberty or property other than in accordance with due process of law
6. the right to ensure confidential communications with spouses or lawyers are not used as evidence against oneself.

Thus, it is hardly surprising that Article IV of the Bill of Rights to the United States Constitution entrenches the common law.

The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.

Article V goes on to protect the right not to be forced to incriminate oneself and to protect life, liberty and property against unlawful deprivation.⁹

It is contrary to sovereignty to expect the citizens of country A to do anything to help country B collect taxes from country B's citizens or residents—all the more so if to do so would involve country A violating the civil rights of its own citizens. Accordingly, any self-governing jurisdiction would be entitled to insist that due legal process and judicial supervision be required for any information disclosure to a foreign country. These might include safeguards against abuse such as the following.

Information may only be disclosed pursuant to a local search warrant issued by a Judge upon probable cause supported by a sworn statement and that damages will be payable if that sworn statement cannot be supported or represents an abuse of process.

- Information may only be disclosed where it may be relevant to an offence against that country's laws not any other country's laws.
- Spouses and family members should not be compelled to give evidence against each other.
- Information sought and obtained for one purpose should not be abused by being used for another and should not be admissible in any other proceedings against any person other than the person in respect of whom it was requested.

To take a hypothetical example from current circumstances, the vast majority of humanity would be happy to provide voluntarily any information they could to ensure that such things as the World Trade Center attacks never happen again. But, a US resident who happily assisted the FBI trace through an overseas bank account might be more than upset if that information was subsequently turned over to the US Internal Revenue Service and used to convict him for non-disclosure of a foreign bank account for tax



purposes. In a similar way, OFCs and their business sectors have shown themselves willing to cooperate against common criminality, but that does not mean they are willing to see their investors scared away by implied threats that their private financial affairs will be disclosed upon request to any OECD tax collector or regulatory authority.¹⁰

If OFCs wish to attract or retain private client business, it is therefore essential that there be very strong safeguards on any process of exchange of information from OFCs to the OECD or other countries. Information on private client affairs should only be supplied to other countries where genuinely required for investigation of common criminality and subject to the normal legal rules on warrants, immunities, admissibility, and so forth.

'Misuse' of corporate vehicles for illicit purposes?

While it is possible to imagine offshore corporate vehicles being misused for illicit purposes, it does not follow that every attempt to secure offshore financial privacy is illegitimate. It is illogical for the OECD to imply that any legal system which offers secrecy or confidentiality is therefore *ipso facto* suspect or that offshore governments should insist that records of beneficial ownership of companies be available for OECD tax or other investigators in cases outside the scope of common criminality.

Most legal systems, including those of OECD countries, protect privacy and require secrets and confidences to be kept—for example, German, Austrian or Swiss bank secrecy. The English law of wills recognises the ability of testators to create secret or semi-secret trusts for the benefit of others such as illegitimate children or mistresses. Breaches of confidence can be stopped by injunctions in equity. Nor do trustee owners of company shares have to disclose beneficial ownership

except in certain circumstances. Partnerships can be silent, both in England and in Europe.

All commerce is about competition. Competition means ensuring that competitors do not gain an insight into your strengths or weaknesses. Competition requires confidentiality regarding any number of business activities, from cost of manufacture and pricing, customer and supplier lists and contracts to the development of intellectual property. Secrecy can help a company keep its markets and avoid boycotts. For example, British firms dealing simultaneously with both South Africa and other African countries or both Israel and Arab states seem to have put considerable commercial value on secrecy.

Although many uses of OFCs involve attempts to secure privacy in order to get around various forms of economic or social regulation in the country of the investor, it does not necessarily follow that attempts by an investor's home country to enforce its economic or social regulations through information disclosure should be accorded the same respect as requests for assistance in normal law enforcement.

Investors may use offshore financial vehicles and financial privacy for tax planning which, as noted above, does not necessarily mean tax evasion. An investor engaging in perfectly legal tax planning may seek financial privacy because he does not want to risk the disruption and expense of onshore litigation to prove the correctness of his position. Furthermore, there is nothing morally or legally wrong with trying to keep secret one's successful commercial or legal strategies.

To take another example, investors may use offshore financial vehicles for insider trading. Insider trading has an interesting history. Until recently, it was not a criminal offence in the European Union. Legal academics and economists still disagree as to how insider trading should be defined and how broad the scope of the offence should



be. At one end of the academic spectrum is the argument that insider trading should never be an offence since it hastens the dissemination of price sensitive information in the market. Arguably, given the fiduciary duties of directors, it may be wrong for a company director in possession of company information to trade in their shares (as a shareholder, one may certainly think so). But, is it wrong for a mere passer-by who overhears an interesting conversation and subsequently buys shares on the basis of what was heard? These are contentious issues and the most appropriate approach to take regarding such economic regulation is not immediately obvious. Thus, a country may agree that *some* forms of insider trading are within the rule on common criminality but refuse to accept another country's view that all insider trading constitutes an offence.

Another case is where offshore financial vehicles involve exchange control planning. Again, why should a country with no exchange controls be expected to disclose information so that another country can enforce its repressive financial regulation?

As mentioned above, offshore structures are commonly used for asset protection from creditors, spouses or forced heirship rules. Again, is it necessarily wrong for a prudent businessman to wish to protect assets from such claims? Similar considerations arise where we are talking about use of domestic companies or trusts to evade marital community property laws or forced heirship. The morality of such asset protection must depend entirely on individual circumstances. No one can generalise that all attempts to use offshore vehicles to avoid or evade lawsuits, marital property regimes, forced heirship, divorce courts or testator's family maintenance orders are morally wrong.

There is nothing inherently wrong in countries competing to provide investors with a choice between differing legal systems. It is reasonable to assume that most people in most countries are generally happy with

their legal systems and that those legal systems represent, even if only indirectly, the views of a majority of citizens. If this were not the case, those systems would not be what they are. However, a significant number of people residing in a particular country may not find the local laws to their liking. For example, an English businessman living in France may not like the French marital community property system or the French commercial code. He may therefore wish to avoid both by using Jersey trusts and companies to hold assets and run his international business interests. Ultimately, an individual's ability to choose the laws of one jurisdiction rather than another involves considerations of individual freedom as well as national sovereignty. If a significant number of individuals or entities choose an offshore jurisdiction, the home country may well have reason to revisit its own taxation policies as part of a self-critical examination in the light of tax competition, rather than attack offshore jurisdictions.

The very real risk for an OFC is that if it agrees to unrestrained information disclosure on the financial affairs of its private client investors to their home countries for all sorts of civil law, tax or other economic regulatory purposes it will very soon be out of business. It will be throwing away the advantages of engaging in international commerce (which the Internet is now providing). It will be throwing away its sovereign right to seek prosperity by providing people from other countries with different choices of legal regime to govern their assets and business affairs. Paradoxically, there is also a risk for OECD countries that, if OFCs are shut down, the incentive arising from international taxation competition, when seen as a practical driver for the creation of better, more economically efficient taxation systems, will cease to exist, further harming domestic growth and prosperity for all nations concerned, not just the small developing economies.



Information exchange treaty protections

Because civil rights and due process, as well as economic prosperity, may depend so much on how information exchange is handled by OFCs in the future, it is worth summarising what would be useful provisions to have in relation to a treaty for information exchange with foreign governments. It is assumed that any information exchange has to be predicated on a legal assistance framework which respects the rule on common criminality and which acknowledges that fiscal matters are outside the scope of common criminality.

First, a request for information might need to be supported by sworn statements which could be tested before a local judge. From the point of view of protecting human rights and rights of private property, local citizens are likely to find it totally unacceptable if their legal and constitutional rights can be swept aside merely by the action of a foreign official. Arbitrary searches and seizures are unlikely to be attractive to foreign investors.

Second, one might expect there to be immunities for use and derivative use of information supplied. For example, if a foreign government seeks information relating to drug trafficking by person X, it should not be able to use that information to prosecute person Y for an unrelated offence. Such immunities would be required both for foreigners and local residents. No country can be expected to force its citizens to disclose information to a foreign country when such disclosure would expose its citizens or public officials to arrest when visiting that foreign country.

The crucial point is that information disclosure under any treaty has to be seen as thoroughly governed by legal due process. Legitimate investors in OFCs should not be worried by information exchange on matters of common criminality, but they will be

entitled to worry if information exchange amounts to unilateral disclosure for the purposes of their home country's economic or fiscal regulatory purposes. The truth of the matter is that governments themselves compete for investment and compete in terms of offering different legal and fiscal systems. The United States and United Kingdom are well-known tax havens for foreign investors and they have richly profited from being so.

Investors often place their monies in or through OFCs precisely because they want to take advantage of tax and regulatory competition. Such economic competition not only benefits the OFCs themselves but the broader world economy. It is therefore unrealistic for OECD countries to expect other countries to agree to information disclosure on such lax terms that the investment attractiveness of those non-OECD countries is destroyed.

Notes

- ¹ See for example, Gaffney (1999), Dwyer (2000), Dwyer and Dwyer (2001). There has been considerable criticism of the OECD by members of the US Congress, and the Centre for Freedom and Prosperity in Washington has usefully assembled a great deal of such criticism on its website, www.freedomandprosperity.org. The Commonwealth Secretariat in London has also defended the rights of small Commonwealth countries to formulate their own tax policies.
- ² Given this OECD admission, one might have thought that an OFC agreeing to cooperate with the OECD's demands would be rewarded with removal of the countermeasures, but removal of existing countermeasures is not offered by the OECD.
- ³ William Pitt, 'Taxation is no part of the governing or legislative power. The taxes are a voluntary *gift* or *grant* of the Commons alone...The distinction between legislation and taxation is essentially necessary to liberty.' (14 January 1766) 'The spirit of



resistance to your arbitrary system of taxation might have been foreseen; it was obvious from the nature of things, and of mankind...The spirit which now resists your taxation in America is the same which formerly opposed loans, benevolences and ship-money in England; the same spirit which called all of England on its legs, and by the Bill of Rights vindicated the English Constitution; the same spirit which established the great fundamental, essential maxim of your liberties—that no subject shall be taxed but by his own consent' (20 January 1775), reprinted in MacArthur, (1996:71, 79).

⁴ Also called 'defensive measures'. This language of economic warfare smacks of neo-mercantilism. Incidentally, one wonders why any country subjected to countermeasures, such as interference with its normal commercial banking, would have any incentive to cooperate much with OECD countries on far more important matters (such as fighting drug trafficking or terrorism). The OECD threats of sanctions for merely pursuing one's sovereign tax policies could end up undermining the willing cooperation against serious crime which currently exists.

⁵ The House of Lords reversed the Court of Appeal in *In re State of Norway (No.1)*, (H.L. Feb. 16, 1989), holding that simply providing evidence to another state for that state to use to enforce its revenue laws does not constitute the direct or indirect enforcement of another state's revenue laws. The decision highlights new possibilities of information disclosure to foreign revenue authorities from common law countries in civil and criminal tax cases, especially between governmental authorities. The correctness of the decision, however, seems open to doubt as being inconsistent with the previous authority and it is not binding outside the United Kingdom. Jeffery (1999:117–19) argues that mutual tax law enforcement strengthens each country's sovereignty over its own citizens but he does not address arguments such as those presented here or in Dwyer (2000). His thesis seems to assume a world of like countries with like views.

⁶ See OECD (2001) for an interesting essay on misuses of corporate vehicles, though one might note that many of the practices it criticises occur under laws imported from OECD countries in their former role as colonial powers. One also notes that corporate collapses and scandals in OECD countries are hardly a thing of the past.

⁷ The OECD does not seem to recognise the underlying logical contradiction between supporting market economies and private property on the one hand while pushing with the other for 'transparency' to invade investors' privacy.

⁸ Smith wisely anticipated the legal and economic consequences of the OECD tax agenda, noting that

...the quantity and value of the land which any man possesses can never be a secret, and can always be ascertained with great exactness. But the whole amount of the capital stock which he possesses is almost always a secret, and can scarce ever be ascertained with tolerable exactness. It is liable, besides, to almost continual variations... Secondly, land is a subject which cannot be removed; whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages



of labour would necessarily be more or less diminished by its removal (1776:848–49).

⁹ 'No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation'.

¹⁰ It is notable that no evidence seems to have emerged to date of any terrorist financing being undertaken through offshore centres (all of which have been willing to cooperate with US law enforcement agencies). This may not be so surprising; offshore centres are often small and more closely regulated than large financial centres.

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